> companies. Absent some prospect of recovering those expenditures -- and more -- few inventors would be inclined or able to pursue innovations. The result over the long term would be fewer innovations, a slower rate of technological change, and slower improvements in the standard of living for society as a whole.[32]

The Commission has recognized the foregoing principle in the requirements the Commission has previously established for the pricing of new services. Acknowledging that "a brief period of relative flexibility will strengthen carrier incentives to innovate," the Commission has permitted carriers to offer new services outside of the constraints of the price cap for a limited period of time.[33]

B. Increased Flexibility In The Pricing Of New Services Would Give Local Exchange Carriers Greater Incentive To Innovate Through New Service Offerings.

In its Order, the Commission requires LECs to establish prices for new services that provide a positive net revenue that satisfies the net revenue test and are justified by a showing of direct costs and an appropriate level of overhead costs. A LEC may establish a higher price to recover a "risk premium" if the LEC can make the requisite showing that it is undertaking "a particularly risky venture, which would not be economically practical absent the risk premium."[34]

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32 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Further Notice of Proposed Rulemaking, released May 23, 1988, ¶ 107.

33 Second Report and Order, FCC Rcd. at 6825, ¶ 319.

34 See Order, ¶¶ 42-44.

The effect of the Order is, in many instances, to limit prices for new services by applying the traditional cost tests that were applied under rate of return regulation. The objectives of the Commission's program of incentive regulation would be better served if the LECs were allowed greater flexibility in the pricing of new services.

If the LECs are to be incented to deploy new services, they should be allowed to price new services to include earnings on expenses not included in the traditional cost showings. In developing and deploying new services and features, increasing portions of total cash outlays are treated as expense. Large expenditures are frequently required over a period of time for research and development, product planning and marketing, and customer education and support services. In addition, the development of many new services now often requires significant software enhancements, which are typically treated as expenses. Upgrades in operating systems that must go hand-in-hand with technological upgrades in the network are generally treated as expenses. The amount of dollars booked to expense required in today's environment, relative to the amount of capitalized dollars required, is in marked contrast to network investments of the electro-mechanical switching era when the preponderance of investment was hardware-related and capitalized. Limiting earnings to those on capitalized investment dollars only, denies a "return" on these substantial one-time expenses, notwithstanding that these dollars must also compete within the firm with other investment alternatives.

The LECs have no economic incentive to develop new services if they cannot earn on one-time expense dollars, some of which may have been spent in the past, and they are limited to earning on new services at the allowed rate of return on the capitalized portion only. Viewing their business in simplest terms, LECs are typically faced with two investment alternatives: investing to offer new services or investing to reduce operating expenses. The figures in the attached Appendix show why a LEC will always choose the alternative of reducing expenses if earnings on new services are constrained as described above. Lack of pricing flexibility is thus incompatible with the Commission's stated objective to encourage innovation.

Greater flexibility in the pricing of new services is also justified by risk factors of a type not expressly addressed by the Commission in its Order. These include such factors as volatility of the marketplace and premature obsolescence. In addition, there are business risks inherent in the development of new services. Development activities are risk-based by their nature, and will inevitably and necessarily involve some products that ultimately cannot be offered or that must be withdrawn from the market. The pricing of the "successful" new products must be sufficiently high to cover the costs associated with these risks of being in the business of developing new services.

Finally, limiting earnings to fully distributed costs may also conflict with the requirement that a new service be priced to satisfy the net revenue test. The net revenue test

ensures that a company's net revenues are greater if a particular new service is offered than if it is not.[35] Included as part of the net revenue test is the consideration of cross-elastic effects of the new service and, therefore, the total revenue effect on the company is addressed.[36] By contrast, a determination of fully distributed costs focuses solely on the particular service in question, without regard for the effect that its price will have on revenue on a company-wide basis.

As a result, in some instances, pricing a service at fully distributed costs may result in failure to satisfy the net revenue test. In these circumstances, irrespective of fully distributed costs, a LEC should be permitted to price a new service at a level that not only "passes" the net revenue test, but permits the LEC to earn at a level above that "break even" point that is significant enough to incent innovation. Denying a LEC that opportunity would further impede innovation by eliminating economic incentives to develop new services.

For the foregoing reasons, the Commission's objectives could best be achieved by allowing the LECs, as a matter of course, to price new services to earn on the combined total of capitalized dollars and one-time expenses, at a level above the

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35 Second Report and Order, 5 FCC Rcd. at 6852, n.416.

36 An additional consideration applies to the pricing of services that the NTCs offer first in the states and later introduce in the federal arena. In those instances, the Commission should allow the BOCs the flexibility needed to prevent signficant arbitrage between the state and federal tariffs.

authorized rate of return. The NTCs request that the Order be modified to permit greater flexibility in new service pricing, as described above, so that the benefits of incentive regulation can be fully realized.

C. Adequate Safeguards Exist To Insure Just, Fair And Reasonable Pricing Of New Services.

As the Commission has acknowledged, the NTCs have made a firm commitment to cost-based, fair and reasonable pricing for new ONA services.[37] Moreover, numerous safeguards are already in place to protect against unreasonably high rates for all new services. These safeguards include:

- Definition of New Services -- By defining new services as expanding customers' options,[38] the Commission assures that no existing service will be replaced by a new service. Customers will be no worse off -- indeed they stand to benefit -- since they will have additional choices.
- Net Revenue Test -- The LECs' new service tariff filings must substantiate that prices cover incremental costs.
- Marketplace Constraints -- The pricing of new services will be limited by competition since customers will have the ability to choose from all existing services, plus alternative services available in the marketplace (such as those offered by alternative local fiber providers, microwave and satellite systems, interexchange carriers and resellers).

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37 See BOC ONA Amendment Order, 5 FCC Rcd. at 3112-13, ¶ 84; BOC ONA Order, 4 FCC Rcd. at 166-67, ¶ 317. See also April 15, 1991 ONA Plan Amendments, pp. 18-19; Amended ONA Plan, pp. 30-32.

38 See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Order on Reconsideration, released April 17, 1991, 6 FCC Rcd. 2637, 2693, ¶ 122 (1991).

- Tariff Review -- New services must be filed on 45 days' notice. This permits ample time for scrutiny and possible intervention or Commission action.

- Quarterly New Services Reporting -- The monitoring of new services through LEC quarterly reports will provide actual results for comparison with projections used in the net revenue test, beginning six months after deployment of the new service.

- Sharing Rules -- Any earnings from new services will be part of the revenues subject to sharing.

- Price Cap Baskets And Bands -- New services will be incorporated into price cap baskets and bands, and be subject to the productivity offset and subindex restraints, at the next annual filing after introduction.

The foregoing safeguards and the NTCs' commitment to cost-based, fair pricing for new ONA services ensure fair, just and reasonable pricing of new services.

Appendix

Figure A compares two alternatives for investing $1M: Alternative #1 -- investing to produce new revenues through a new service offering and Alternative #2 -- investing to reduce expenses. In both Alternatives #1 and #2, outlay of cash to be capitalized is $600K and expense is $400K.[1] In Alternative #1, net revenues are increased by $315K (revenues of $350K less new expenses of $35K). In Alternative #2, net expenses are reduced by $315K. Both Alternatives #1 and #2 cause net income to increase by $135K and overall rate of return to increase from 11.25% to 11.34%.

The return on the capitalized portion of the investment in the new service in Alternative #1 is 22.50%. Pricing to permit the net revenue increase of $315K shown in Alternative #1 would not be permitted if earnings were limited to a 11.25% rate of return. Alternative #3, on Figure B, shows that applying an 11.25% rate of return constraint to the new service offering would reduce the permitted increase in gross revenues from $350K (shown on Figure A, Alternative #1) to $262.5K. No such constraint would be applied in the case of Alternative #2, the expense-reduction investment alternative. As a result, Alternative #2 is a better investment alternative than the new service investment Alternative #3.

One way to encourage new service investment, instead of expense-reduction investment, would be to allow earnings on the entire $1M of investment, including the total $400K of expense as well as the $600K of capitalization. The improvement in net income that would result is shown by comparison of Alternative #4 on Figure C to Alternative #3. However, the new service investment choice in Alternative #4 is still inferior to expense-reduction investment Alternative #2. Because of the 11.25% rate of return constraint applied to the new service alternative, net income increases only to $112.5K and the overall rate of return increases only to 11.31%. By comparison, the expense-reduction investment shown in Alternative #2 results in net income increase of $135K and an overall rate of return of 11.34%.

Alternative #5 on Figure D shows that the new service investment alternative compares favorably to the expense-reduction investment alternative only if earnings are permitted on expense outlays and earnings are not limited to 11.25%.

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1 In both Alternatives #1 and #2, it is assumed that the $400K one-time expense has been spent in the past and is recovered at a rate of $80K per year, treated as a current expense. While this would recover the $400K over a five-year period, it does not provide for any return in the $400K cash outlay.

ANALYSIS OF INVESTMENT ALTERNATIVES

		ALTERNATIVE #1 INVEST $1M IN REVENUE PRODUCING NEW PRODUCT OR SERVICE		ALTERNATIVE #2 INVEST $1M IN OPERAT'L IMPROVEMENTS TO REDUCE EXPENSES	
	BASE CASE	CHANGE	TEST CASE	CHANGE	TEST CASE
INVESTMENT CHANGE:					
CAPITAL		600,000		600,000	
EXPENSE		400,000		400,000	
TOTAL		1,000,000		1,000,000	
REVENUES	28,437,500	350,000	28,787,500	0	28,437,500
EXPENSES					
MAINTENANCE	2,500,000	10,000	2,510,000	(160,000)	2,340,000
ADMINISTRATION	2,500,000	10,000	2,510,000	(160,000)	2,340,000
MARKETING	2,500,000	10,000	2,510,000	0	2,500,000
OTHER EXPENSES	2,500,000	5,000	2,505,000	5,000	2,505,000
TOTAL	10,000,000	35,000	10,035,000	(315,000)	9,685,000
1-TIME EXPENSES					
PROD. DEVELOPMENT	0	50,000	50,000	0	0
SOFTWARE RTU	0	350,000	350,000	400,000	400,000
TOTAL	0	400,000	400,000	400,000	400,000
RECOVERY OF 1-TIME EXP.	0	80,000	80,000	80,000	80,000
DEPRECIATION	7,500,000	60,000	7,560,000	60,000	7,560,000
INCOME TAX	2,500,000	40,000	2,540,000	40,000	2,540,000
NET INCOME	8,437,500	135,000	8,572,500	135,000	8,572,500
INVESTMENT	75,000,000	600,000	75,600,000	600,000	75,600,000
RATE OF RETURN	11.25%	22.50%	11.34%	22.50%	11.34%

FIGURE A

ANALYSIS OF INVESTMENT ALTERNATIVES

		ALTERNATIVE #3 INVEST $1M IN REVENUE PRODUCING NEW PRODUCT OR SERVICE		ALTERNATIVE #2 INVEST $1M IN OPERAT'L IMPROVEMENTS TO REDUCE EXPENSES	
	BASE CASE	CHANGE	TEST CASE	CHANGE	TEST CASE
INVESTMENT CHANGE:					
CAPITAL		600,000		600,000	
EXPENSE		400,000		400,000	
TOTAL		1,000,000		1,000,000	
REVENUES	28,437,500	262,500	28,700,000	0	28,437,500
RECURRING EXPENSES					
MAINTENANCE	2,500,000	10,000	2,510,000	(160,000)	2,340,000
ADMINISTRATION	2,500,000	10,000	2,510,000	(160,000)	2,340,000
MARKETING	2,500,000	10,000	2,510,000	0	2,500,000
OTHER EXPENSES	2,500,000	5,000	2,505,000	5,000	2,505,000
TOTAL	10,000,000	35,000	10,035,000	(315,000)	9,685,000
1-TIME EXPENSES					
PROD. DEVELOPMENT	0	50,000	50,000	0	0
SOFTWARE RTU	0	350,000	350,000	400,000	400,000
TOTAL	0	400,000	400,000	400,000	400,000
RECOVERY OF 1-TIME EXP.	0	80,000	80,000	80,000	80,000
DEPRECIATION	7,500,000	60,000	7,560,000	60,000	7,560,000
INCOME TAX	2,500,000	20,000	2,520,000	40,000	2,540,000
NET INCOME	8,437,500	67,500	8,505,000	135,000	8,572,500
INVESTMENT	75,000,000	600,000	75,600,000	600,000	75,600,000
RATE OF RETURN	11.25%	11.25%	11.25%	22.50%	11.34%

FIGURE B

ANALYSIS OF INVESTMENT ALTERNATIVES

		ALTERNATIVE #3 INVEST $1M IN REVENUE PRODUCING NEW PRODUCT OR SERVICE		ALTERNATIVE #4 INVEST $1M, EARNING ON ONE-TIME EXPENSE	
	BASE CASE	CHANGE	TEST CASE	CHANGE	TEST CASE
INVESTMENT CHANGE:					
CAPITAL		600,000		600,000	
EXPENSE		400,000		400,000	
TOTAL		1,000,000		1,000,000	
REVENUES	28,437,500	262,500	28,700,000	320,500	28,758,000
EXPENSES					
MAINTENANCE	2,500,000	10,000	2,510,000	10,000	2,510,000
ADMINISTRATION	2,500,000	10,000	2,510,000	10,000	2,510,000
MARKETING	2,500,000	10,000	2,510,000	10,000	2,510,000
OTHER EXPENSES	2,500,000	5,000	2,505,000	5,000	2,505,000
TOTAL	10,000,000	35,000	10,035,000	35,000	10,035,000
1-TIME EXPENSES					
PROD. DEVELOPMENT	0	50,000	50,000	50,000	50,000
SOFTWARE RTU	0	350,000	350,000	350,000	350,000
TOTAL	0	400,000	400,000	400,000	400,000
RECOVERY OF 1-TIME EXP.	0	80,000	80,000	80,000	80,000
DEPRECIATION	7,500,000	60,000	7,560,000	60,000	7,560,000
INCOME TAX	2,500,000	20,000	2,520,000	33,000	2,533,000
NET INCOME	8,437,500	67,500	8,505,000	67,500	8,505,000
EARNINGS ON 1-TIME EX	-	-	-	45,000	45,000
TOTAL NET INCOME	8,437,500	67,500	8,505,000	112,500	8,550,000
INVESTMENT	75,000,000	600,000	75,600,000	1,000,000	75,600,000
RATE OF RETURN	11.25%	11.25%	11.25%	11.25%	11.31%

FIGURE C

ANALYSIS OF INVESTMENT ALTERNATIVES

		ALTERNATIVE #3 INVEST $1M IN REVENUE PRODUCING NEW PRODUCT OR SERVICE		ALTERNATIVE #5 INVEST $1M, EARNING ON ONE-TIME EXPENSE	
	BASE CASE	CHANGE	TEST CASE	CHANGE	TEST CASE
INVESTMENT CHANGE:					
CAPITAL		600,000		600,000	
EXPENSE		400,000		400,000	
TOTAL		1,000,000		1,000,000	
REVENUES	28,437,500	262,500	28,700,000	345,000	28,782,500
EXPENSES					
MAINTENANCE	2,500,000	10,000	2,510,000	10,000	2,510,000
ADMINISTRATION	2,500,000	10,000	2,510,000	10,000	2,510,000
MARKETING	2,500,000	10,000	2,510,000	10,000	2,510,000
OTHER EXPENSES	2,500,000	5,000	2,505,000	5,000	2,505,000
TOTAL	10,000,000	35,000	10,035,000	35,000	10,035,000
1-TIME EXPENSES	0				
PROD. DEVELOPMENT	0	50,000	50,000	50,000	50,000
SOFTWARE RTU	0	350,000	350,000	350,000	350,000
TOTAL	0	400,000	400,000	400,000	400,000
RECOVERY OF 1-TIME EXP.	0	80,000	80,000	80,000	80,000
DEPRECIATION	7,500,000	60,000	7,560,000	60,000	7,560,000
INCOME TAX	2,500,000	20,000	2,520,000	35,000	2,535,000
NET INCOME	8,437,500	67,500	8,505,000	81,000	8,518,500
EARNINGS ON 1-TIME EX	-	-	-	54,000	54,000
TOTAL NET INCOME	8,437,500	67,500	8,505,000	135,000	8,572,500
INVESTMENT	75,000,000	600,000	75,600,000	1,000,000	75,600,000
RATE OF RETURN	11.25%	11.25%	11.25%	13.50%	11.34%

FIGURE D

CERTIFICATE OF SERVICE

I certify that copies of the foregoing DIRECT CASE OF THE NYNEX TELEPHONE COMPANIES were served on each of the parties listed on the attached Service List, this 18th day of May, 1992, by first class United States mail, postage prepaid.

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